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In the Matter of)

Price Cap Performance Review)
for Local Exchange Carriers)

CC Docket No. 94-1

COMMENTS OF THE
NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

The National Telephone Cooperative Association ("NTCA") submits the following comments in response to the Commission's Notice of Proposed Rulemaking, FCC 94-10, released on February 16, 1994, in the docket captioned above ("NPRM"). By this NPRM, the Commission has initiated its scheduled review of the performance of some local exchange carriers ("LECs") under price caps. NTCA is a national association of approximately 500 LECs providing telecommunications services to subscribers and interexchange carriers throughout rural and small-town America.

I. PRICE CAPS ARE NOT SUITED FOR MOST SMALL AND RURAL TELCOS.

NTCA's interest, here and in the proceeding which initially adopted price caps, focuses on the universal service implications of price caps and the effect on small and rural LECs and the subscribers they serve. NTCA is confident that the possible benefits of price caps will not arise if applied to most small and rural LECs. The challenging service characteristics of these LECs makes the price-cap conceptual approach unsuitable.

Price caps require a commitment on the part of carriers to abide by prescribed productivity gains over a period of years. Productivity, according to the plan, is defined and measured on

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the basis of a cost-per-demand-unit measure.

The cost of telecommunications networks in sparsely populated areas is high as an initial matter. The ongoing ability of the LECs serving these areas to find innovative ways to limit cost or cost growth and to maintain the same quality of service is questionable and, in any case, unpredictable. With relatively less control over technological developments, they could be forced to look only to cost cutting, to the detriment of service availability and quality.

Small and rural LECs are highly dependent on the telecommunications services' demands of subscribers occupying a small geographic area and the existence and health of a small number of local businesses or industries. It is the unpredictability and potential volatility of the demand denominator of the productivity measure that most makes price caps unsuitable for application to small and rural LECs.

The point to this discussion is that the expected benefits of price caps will not always arise in all applications. Faced with a commitment to lower prices (and endure lower revenues) to meet a specific quotient of cost divided by demand, without control over technology cost or demand growth, small and rural LECs under price caps could find themselves in the position of being forced into cost cutting, service degrading changes, or alternatively enduring losses.

NTCA commends the Commission, in its initial price-cap decision, for its recognition of LEC diversity and the need to

promote universal service goals by concluding that "a single compulsory price-cap system would unfairly burden some, particularly smaller carriers."¹ The instant NPRM is silent with respect to this former recognition. As price caps become ingrained into the Commission's operation, and as administration of the plan is transferred to successive Commissions and staff, an understanding of the unsuitable applicability and need for permanent optionality for small LECs should not be forgotten. Accordingly, in its fourth-year review conclusion, the Commission should once again state its commitment to the maintenance of other, more viable forms of regulation, including traditional rate-of-return forms, and the permanent optionality of price caps for those LECs unsuited to their design.²

II. THE FUTURE OF THE UNITARY RATE OF RETURN SHOULD BE SETTLED.

If small and rural LECs are to continue to operate in high cost areas unattractive to competitive, free-enterprise providers, if they are to be able to continue their commitment to universal service and infrastructure development for rural

¹ Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 4 FCC Rcd 2873 (1989) at paras. 623 and 626.

² In recent years, the industry has proposed and the Commission has adopted other forms of regulation that attempt to invoke similar incentives as price caps for smaller LECs. See Report and Order, Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-135, released June 11, 1993; Public Notice, Proposed Revision of Section 69.605 of the Commission's Rules to Allow Small Cost Settlement Companies to Elect Average Schedule Settlement Status, RM-8357, released Oct. 1, 1993; and Public Notice, Proposed Revisions of Part 69 of the Commission's Rules to Allow for Incentive Settlement Options for NECA Pool Companies, RM-8389, released Nov. 16, 1993.

subscribers, and if they are to have available to them a rate-of-return form of regulation for which the need is discussed above, then a unitary rate of return must be maintained in some form. Several provisions of the Commission's access plan employ rate-of-return methods including Universal Service Fund calculations made by all LECs, tariff rates and pool settlements for those LECs that participate in the pools administered by the National Exchange Carrier Association ("NECA"), and the revenue requirement and rate calculations for non-Tier 1 LECs not opting for price caps.³ The maintenance of an industry-wide, unitary rate of return continues to be crucial to the continuance of these worthy provisions.

In the early rounds of comments leading to the initial adoption of price caps for the large LECs, NTCA urged the Commission to resolve rate-of-return issues in CC Docket No. 87-463 on a parallel track with the price-cap proceeding.⁴ In CC Docket No. 92-133, NTCA maintained that cost of capital data obtained from the Bell operating companies should continue to serve as the surrogate for the cost of capital for the entire industry.⁵

In the instant NPRM, several potential actions again bring into question the manner in which the industry-wide, unitary rate

³ Rate development for new services of price cap carriers also may still depend on cost determinations based on a rate of return on net investment.

⁴ See, e.g., Reply Comments of NTCA filed on September 9, 1988, in CC Docket No. 87-313 at 3-8.

⁵ Comments of NTCA filed Sept. 11, 1992, at 1-5, and Reply Comments filed Oct. 13, 1992, at 1-4, in CC Docket No. 92-133.

of return will be maintained in a price-cap era. A number of the review issues will lead to an evaluation of the performance of the price-cap carriers measured against other cost-of-capital return measures. For example, the Commission is examining whether there should be a one-time adjustment to price indices to reflect changes in interest rates over the last few years.⁶ More directly, the Commission is examining whether profit levels under price caps are reasonable.⁷ Most relevant, the Commission asks "[w]hether the sharing and low-end adjustment mechanisms should be realigned with capital costs, and if so, how this should be done."⁸ Regardless of one's position on these questions, these evaluations will invoke comparisons to other cost-of-capital results and will necessarily bring into question what a reasonable rate of return should be. These questions suggest that the instant NPRM may very well serve to define what a new rate of return may be for the LEC industry. Moreover, the NPRM suggests more directly that the Commission may also consider eliminating the sharing and low-end adjustment mechanisms.⁹ Consequently, the parallel dependence of the industry's unitary rate of return may be fundamentally lost.

The result of either direction, either to move the determination of a rate of return into the price-cap review proceeding or to segregate price-cap carriers from the

⁶ NPRM at paras. 44-46.

⁷ Id.

⁸ Id. at paras. 47-55.

⁹ Id.

represcription of an industry rate of return, could lead to the imposition of inappropriately greater burdens on small and rural telcos. These burdens could involve costly, direct participation in represcription proceedings and possibly complex and lengthy filings to justify capital costs for carriers that do not possess the necessary financial data for such justification.

The Commission has formerly concluded that "price cap regulation should not disturb our longstanding practice of employing a unitary rate of return for the local exchange industry, thereby ensuring that access rate determinations for those remaining under rate of return and the support mechanisms associated with access charge revenue requirements are unaffected by the implementation of a price-cap system."¹⁰ All four of the major, national LEC trade associations are on record with widespread support for a unitary rate of return and have asked the Commission to seek comment and resolution with respect to methodologies and data submissions to be used in conjunction with price caps.¹¹ In CC Docket No. 92-133, the Commission set out to fulfill this request.¹² Once again, virtually the entire LEC industry was in agreement with maintaining the unitary approach.

¹⁰ Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873, 3276 (1989).

¹¹ See letter dated November 4, 1988, submitted in CC Docket Nos. 87-313 and 87-463 by NTCA, the United States Telephone Association, the National Rural Telecom Association, and the Organization for the Protection and Advancement of Small Telephone Companies.

¹² Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, 7 FCC Rcd 4688 (1992).

NTCA's position also recognized that simplification of the rate-of-return represcription process was consistent with ongoing developments in the LEC industry, most notably the introduction of price caps for the larger carriers.¹³

Industry consensus, a substantive record, and the need for coordination between price-cap decisions and rate-of-return prescription issues have already been established. In the instant proceeding, the Commission should use this record and settle the future of the unitary rate of return under the price-cap plan.

III. ARMS-LENGTH TRANSACTIONS IN THE PUBLIC INTEREST INVOLVING REALIGNMENT OF RURAL TERRITORY THROUGH MERGERS AND ACQUISITIONS SHOULD NOT BE THWARTED BY UNNECESSARY PENALTIES ON THE PARTIES.

The LEC industry is currently undergoing some realignment of rural exchanges resulting in the acquisition by small and rural LECs of property previously held by large price-cap carriers. This activity is supported by the local subscribers affected by the realignment, nearly unanimously approved by state commissions, and clearly in the vast majority of the cases, even to nonexperts, in the public interest. The instant NPRM, however, asks for comments on possible vague modifications to the price-cap plan that would result in unwarranted penalties on the merger and acquisition parties.

LECs are realigning their properties to seek more homogeneous business plans for both parties to the transactions. Large LECs, faced with finite capital, obviously must concentrate

¹³ See Comments filed by NTCA on September 11, 1992, in CC Docket No. 92-133.

on high volume and more competitive markets. Small LECs, by acquiring exchanges similar to their existing service area, add greater economy of scale to their homogeneous rural operations, introduce the will of a management solely experienced in and committed to rural network development, make available rural LEC capital sources for network upgrades, and operate under a form of regulation more suited to these areas than price caps.¹⁴

The Commission suggests consideration of new provisions to prevent what it calls "unintended windfalls and transactions that artificially increase subsidies."¹⁵ The apparent concerns leading to these suggestions are unfounded. In accordance with the public interest served by this realignment, the Commission should encourage it.

Even under the most liberal application of the Commission's rules, the realignment of exchanges does not result in any greater cost recovery on society. From the jurisdictional cost separations standpoint, the realignment simply shifts the relative amounts of interstate and state costs. The exchange of property, by itself, does not create any new costs. From another point of view, the realignment removes plant from a LEC most probably earning above the interstate rate of return and transfers it to another LEC that is forced by the rules to earn at this rate of return. It is true that the acquiring company in

¹⁴ "These transactions can also promote better infrastructure development by placing exchanges in control of another LEC whose business plan makes it more committed to developing improved service in the exchange." NPRM at para. 88.

¹⁵ NPRM at para. 88.

these instances will usually upgrade the facilities, leading to initially higher costs and higher rates, but this is the result that public policy should promote, not penalize.

Concerns over the impact on the Universal Service Fund should be answered in the interim by recent Commission actions that cap the total size of this cost recovery component¹⁶ or by anticipated long term modifications to this program. Similarly, the suggestion that there should be exogenous cost reductions for increases in carrier common line ("CCL") rates is likewise unneeded.¹⁷ To the extent that the acquiring LEC is a member of the NECA CCL pool, its rates are capped at the theoretical national average,¹⁸ and in any event, the cost of the common line plant that is transferred is allocated according to a 25 percent gross allocator for which there is no difference among carriers.¹⁹

NTCA agrees that there is merit in requiring price-cap carriers to remove the contributing mathematical effect of the exchanges sold from the carrier's appropriate price-cap indices. However, the apparent result of the suggestions as outlined in the NPRM would be to impose additional exogenous cost deductions on price-cap carriers only when the realignment involves a non-price-cap carrier buyer. The effect of this targeted penalty

¹⁶ Report and Order, CC Docket No. 80-286, released December 23, 1993.

¹⁷ Id.

¹⁸ 47 C.F.R. § 69.105 and § 69.612.

¹⁹ 47 C.F.R. § 36.154(c).

would be that price-cap LECs would no longer sell to rural LECs, the same telcos that present the greatest commitment to rural infrastructure development.

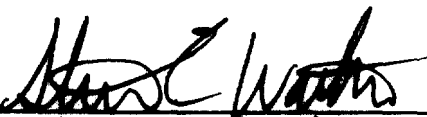
For these reasons, the suggested proposals would be contrary to the public interest and should not be adopted. Price-cap carriers can be required to remove the composite effect of exchanges sold from their controlling price indices. Apart from this adjustment, no other penalties should be considered.

IV. CONCLUSION

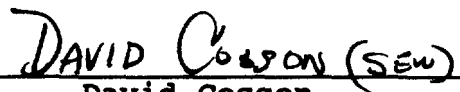
Consistent with the comments above, the Commission should renew its recognition that price caps are unsuitable for application to small LECs. This proceeding should also settle the future of the industry unitary rate of return. Finally, the Commission should not impose unwarranted penalties on parties involved in mergers and acquisitions that would negate the public policy benefits the transactions are designed to serve.

Respectfully submitted,

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May 9, 1994

CERTIFICATE OF SERVICE

I, Rita H. Bolden, certify that a copy of the foregoing Comments of the National Telephone Cooperative Association in CC Docket No. 94-1 was served on this 9th day of May 1994, by first-class, U.S. Mail, postage prepaid, to the following persons on the attached list:

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